FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Delaware's $252 Million GO Bonds 'AAA'; Outlook Stable

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Fitch Ratings - New York - 09 Feb 2022: Fitch Ratings has assigned a 'AAA' rating to the $251.55 million General Obligation (GO) bonds, series 2022 to be issued by the state of Delaware.

The bonds will fund the ongoing capital program and refund outstanding GO bonds for debt service savings. The bonds are scheduled to be sold by competitive bid on or about Feb. 16, 2022.

Fitch has also affirmed Delaware's Issuer Default Rating (IDR) and outstanding GO bonds at 'AAA'

The Rating Outlook is Stable.

SECURITY

The bonds are a general obligation, full faith and credit obligation of the state of Delaware.

ANALYTICAL CONCLUSION

Delaware's 'AAA' IDR and GO bond rating are based on strong financial performance, supported by proactive management and institutionalized protections designed to ensure surplus operations. Long-term revenue growth has accelerated in recent years, and Fitch anticipates it will remain above the long-term level of inflation. The growth allowed the state to fully fund two reserves to a combined 10% of revenues. The long-term liability burden is above the state median, reflecting in part debt issuance for purposes that are addressed at the local government level in most other states.

Economic Resource Base

Delaware's economy is largely based on service-providing enterprises, including financial activities, professional and business services, and education and health organizations. The state has implemented deliberate policies to maintain a climate attractive to banking and related entities. Population growth has trended above the U.S. Per capita personal income growth and levels are slightly below the nation.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Financial operations are supported by a diverse array of revenue sources with the personal income tax (PIT) accounting for the largest share at approximately one-third. Delaware also leverages its status as the legal home to over half of all publicly-traded corporations in the U.S., and assesses taxes on limited partnerships, franchises and other business entities. This structure results in a revenue framework that is particularly sensitive to national economic trends.

Expenditure Framework: 'aaa'

While carrying costs are above the U.S. states median, Delaware has demonstrated the broad expense-cutting ability common to most U.S. states and benefits from the cushion provided by its statutory restriction to budget 98% of expected revenue. Education is a key cost driver, as the state is highly involved with funding local education, including funding employer pension contributions for school district employees.

Long-Term Liability Burden: 'aa'

The state's long-term liabilities are a moderate burden on resources. Debt levels are well above average for a U.S. state, in part due to the state's role in issuance for projects usually funded at the local level, and have recently ticked upward primarily due to transportation-related borrowing. Pension liabilities are also above the median and remain relatively stable. However, other post-employment benefit (OPEB) obligations are sizable, with a recent significant increase due to a change in the discount rate used to calculate the liability.

Operating Performance: 'aaa'

The state has exceptional financial resilience from strong financial management that has contributed to the maintenance of ample financial cushion through economic cycles. The relatively frequent monitoring of revenues and operating expenditures mitigates the effect of volatility in revenues and allows for rapid gap closing.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

--Not applicable given the 'AAA' ratings.

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

--A sustained slowing of revenue growth to below the level of long-term inflation;

--A sustained increase in the long-term liability burden closer to 20% of personal income or an inability of the state to address its large net OPEB liability.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CURRENT DEVELOPMENTS

Delaware Economic Update

Delaware's economic activity and employment fell sharply at the start of the pandemic, with employment declining 15% from its peak, equal to the U.S. rate of job loss. This despite the fact that Delaware kept many industries open, including manufacturing, most professional services and some retail. Employment has rebounded 79% from the trough (as of December 2021), just under the 80% median for U.S. states. Delaware's unemployment rate of 5% (as of December) is above the U.S. states median of 3.9%.

However, the Fitch adjusted unemployment rate for Delaware of 5.6%, which adds back the declines in labor force since February 2020, approximates the U.S. states median of 5.5%. The gap between the official and Fitch-adjusted rates signals the continued labor market disruptions seen in Delaware and nationally. While employment has not fully recovered, the state anticipates a continued rebound, with hard-hit industries including construction and leisure and hospitality beginning to gain traction.

Fiscal Performance Supported by Strong Revenue Collections

Delaware's revenue performance has been stronger than anticipated throughout this period of uncertainty, with the Delaware Economic and Financial Advisory Council (DEFAC) making frequent upward revenue revisions. Fiscal 2021 revenues of $5.39 billion were 19% higher than initially forecast at the start of the fiscal year, led by strong personal income tax revenues that incorporated the receipt of deferred tax revenues accounted for in fiscal 2021 but attributable to fiscal 2020.

Franchise taxes, corporate income taxes, gross receipts taxes, lottery revenues, and realty transfers taxes all exceeded the original budget forecast. The revenue over-performance allowed the state to fully fund its budget stabilization account (BSA), bringing its combined budget reserves (including the BSA and the rainy day fund) to 10% of fiscal 2021 revenues.

Fiscal 2022 revenue collections are continuing the positive trend. In December 2021, DEFAC increased its revenue forecast for fiscal 2021 by $405 million (8%) as compared with the June 2021 forecast, based on an upward revision in personal and corporate income taxes, realty taxes, and gross receipts taxes. Fiscal 2022 revenues are now expected to increase 2.6% as compared to fiscal 2021 rather than being flat to declining as anticipated when the budget was enacted.

The revenue estimate upon which the governor's budget proposal for fiscal 2023 is based, again assumes revenues will be flat on a yoy basis. The governor's budget proposal for fiscal 2023 appropriates 98% of anticipated revenue, maintains a fully funded rainy day fund at

$280 million, sets aside other reserves, and controls ongoing spending by allocating funds to non-recurring expenditures including for capital.

The budget proposal would finance priorities in education, higher education, water resources and economic development, among others. It would provide significant pay increases to state employees to address workforce recruiting and retention challenges. The budget for fiscal 2023 is under consideration by the Delaware legislature.

Delaware has received $925 million under the American Rescue Plan Act (ARPA) and expects to receive $2.4 billion under the Bipartisan Infrastructure law. The state has allocated its share of ARPA funds to statewide technology and capital upgrades, housing development and emergency housing, support for hospitals and healthcare facilities, and investments in non-profit entities in the state.

Revenue Framework

General fund (GF) revenues are dependent on an unusual array of taxes related to business endeavors and financial institutions, linked to companies being legally domiciled in the state. Revenues include franchise and other fees levied on businesses and banks organized under state law as well as corporate income taxes and other fees. These combine to provide approximately one-third of general fund revenues. Abandoned property, which includes accounts and securities derived from the business domiciled in Delaware that revert to the state's general fund when left unclaimed for specific periods, typically accounts another 10% of GF revenues and is subject to significant volatility.

The state levies a personal income tax but not a general sales tax. The personal income tax provides about one-third of GF revenues and has recorded moderate growth over the past several years, offsetting more variable results in corporate-based taxes. Lottery revenues, which include gaming and account for just below 5% of revenues, have been pressured, reflecting growth and competition in nearby gaming venues outside the state.

Historical revenue growth, adjusted for the estimated effect of policy changes, has been above the rate of inflation over the past ten years. This reflects population growth that has been stronger than the U.S. average as well as reliance on higher growth areas of the economy, including in finance and other services. As a result, Fitch anticipates the long-term trend for revenue growth will remain above long-term inflation but trail the pace of national economic growth.

The state has no legal limitations on its ability to raise revenues through base broadenings, rate increases, or the assessment of new taxes or fees.

Expenditure Framework

As in most states, education and health and human services spending are Delaware's largest operating expenses. Education is the larger line item, as the state provides significant funding for local school districts and the public university and college system. The state's education commitment includes sharing the annual employer pension contribution for local school district employees with school districts. Health and human services spending is the second largest area of spending, with Medicaid being the primary driver.

Fitch expects that the pace of spending growth, absent policy actions, will be in line with to marginally above that of natural revenue growth, driven primarily by Medicaid, and require regular budget adjustments to ensure ongoing balance. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. As with all federal programs, Medicaid remains subject to regulatory changes that could affect various aspects of the program. In other major areas of spending such as education, Delaware is able to more easily adjust the trajectory of growth.

Overall, Delaware retains ample ability to adjust expenditures to meet changing fiscal circumstances. While Medicaid remains a notable cost pressure, spending requirements for debt service and pension obligations are higher than for most states, but remain low at 7.2% of fiscal 2021 governmental funds expenditures.

Strong investment returns that have raised pension system funding levels have allowed the state to lower its contribution rate while still making full actuarial payments, creating additional flexibility within the budget. The governor's budget proposal for fiscal 2023 includes a supplemental appropriation for fiscal 2022 to provide a one-time payment to retirees, a one-time payment to fully fund the actuarial cost to the pension fund of the liability resulting from the benefit increase granted on July 1, 2021, as well as an annual appropriation to begin to pre-fund future post-retirement increases.

The state's payments for OPEB have approximated its contributions to the pension system in recent years, reflecting a large OPEB liability. Pension contributions over the past several years have generally approximated the actuarially determined contribution.

Long-Term Liability Burden

As a small state with a minimal number of local governments, Delaware's service functions are highly centralized, leading to above average long-term liabilities for a U.S. state. Per Fitch's October 2021 State Liability Report, the state's total debt and adjusted net pension liabilities equaled 13.1% of 2020 personal income, a level of long-term liabilities that is well above the state median but still considered moderate.

Delaware's Public Employees Retirement System includes nine plans, covering state and local employees, with most of the state's direct liabilities in the State Employees Plan. Exceptional investment returns in 2021 have eliminated the net pension liability for the State Employees Plan on a market value basis and is expected to reduce the state's long-term liability metric calculated by Fitch once reflected in the fiscal 2022 state audit. Fitch anticipates that the metric will be somewhat volatile as investment returns return to more typical levels.

The net OPEB liability of over $9.3 billion equals 17% of 2020 state personal income, a sizeable increase as compared to the prior year that reflects a change in the discount rate used to calculate the liability. As is the case with pension system contributions, the state pays school district OPEB, contributing to the high liability. While Fitch views the OPEB liability as a more flexible obligation compared with pensions, and also more uncertain because of the complex assumptions used to calculate it, the magnitude of the liability given Delaware's already above-average long-term liabilities is a concern.

The commission formed to develop options to address OPEB liabilities, has issued an initial report that proposes transitioning OPEB from pay-go- to pre-funding to reduce the liability over time, as well as modifying the plan and benefits to reduce future liabilities. These recommendations are expected to be taken up by the general assembly in 2022.

Operating Performance

Delaware's ability to respond to cyclical downturns rests with its conservative budget practices, maintenance of reserves, and proactive approach to tracking and forecasting revenues and expenditures throughout the budget cycle. Financial operations are supported by conservative fiscal policies, including a constitutional provision that limits appropriations to 98% of anticipated revenues in the subsequent fiscal year, plus the unencumbered prior year budgetary general fund balance.

In addition to the availability of unencumbered cash balances, the state maintains a fully funded budget reserve account at 5% of general fund revenue. The BRA may only be appropriated to fund an unexpected budgetary deficit and requires super-majority approval in both legislative bodies to access. The funding of additional reserves outside of the BRA and adherence to an appropriations benchmark that tempers spending growth provide additional financial resilience.

The Fitch Analytical Stress Test scenario analysis tool, which relates historical tax revenue volatility to GDP, indicates the higher level of volatility in Delaware's revenue structure relative to other states. Fitch believes the state's close tracking of both revenues and expenditures and frequent revenue forecast updates have historically allowed it to quickly respond to changing economic conditions.

The state closely tracks revenue collections and expenditures during the year and forecasts are updated at least five times each fiscal year through comprehensive reviews by DEFAC. The state proactively reviews its tax policies and makes adjustments to ensure its budgets are balanced. These practices have proven to be critical to sustaining financial balance and support the state's strong operating performance.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

RATING ACTIONS

ENTITY / DEBT ⬍	RATING ⬍	PRIOR ⬍

Delaware, State of (DE) [General Government]	LT IDR Affirmed	AAA Rating Outlook Stable	AAA Rating Outlook Stable
Delaware, State of (DE) /General Obligation - Unlimited Tax/1 LT	LT Affirmed	AAA Rating Outlook Stable	AAA Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 04 May 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Delaware, State of (DE)	EU Endorsed, UK Endorsed

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